THE EFFECT OF SHAREHOLDER ACTIVISM ON CORPORATE STRATEGY

A 2016 NYSE GOVERNANCE SERVICES/EVERCORE/SPENCER STUART SURVEY REPORT

EVERCORE

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SHAREHOLDER ACTIVIST CAMPAIGNS HAVE RISEN PRECIPITOUSLY OVER THE PAST FEW YEARS, fueled by a robust M&A environment, increased economic pressure, and a change in the investor base of most companies. Across the corporate and political spectrum, there are strong advocates for activism; there are also those with equally staunch beliefs that activists distract the work of the board and destruct shareholder value. No matter the lens, most agree activists have changed their approach from "predatory" to "prepared"—often utilizing their vast resources to provide compelling rationale backed by thorough and complex analytics.

At a recent shareholder engagement roundtable comprising corporate executives, board members, investors, and advisers—convened by NYSE Governance Services as part of its Future of Responsibility, Governance, and Ethics (FORGE) initiative—some participants declared their belief that activism has evolved as a practice that is creating companies with better governance and increased value for shareholders, while others emphasized the short-term focus of many activists, which can cause a negative impact on long-term investment and employment, as well as the risk of overleveraging the company.

To better understand the issues and gain broader insight and perspective on the state of shareholder activism, we took to the field to survey more than 300 directors of publicly traded US companies. This report presents our findings.

KEY TAKEAWAYS

- 84% of directors believe most activist shareholders do not represent the interests of all of a company's shareholders, with 85% saying they are simply too focused on short-term performance.
- Two-thirds (63%) of directors surveyed say activism has had no effect on public company boards' ability to attract quality members, and nearly half (47%) think directors who are nominated or placed on a board by an activist can remain independent.
- Three-quarters (78%) of directors believe that activists who push for a change in strategy should be required to hold the company shares for one to three years subsequent to the implementation of that strategy.
- Almost all directors agree that if an activist places a director on a board, that director should never be allowed to take confidential information back to the fund, and the fund should be subject to the same restrictions on pledging and hedging.
- A majority (63%) of directors say it's a good idea to designate a committee or certain individuals to interact with large shareholders.

DIRECTORS' PERCEPTIONS ON ACTIVISM

Despite shareholder activists' position that they have refined their approach during the past decade, the great majority (85%) of directors we surveyed believe activists' intentions remain too focused on short-term performance. Most (84%) also believe they fail to represent the interests of all of a company's shareholders, and 86% say they would not welcome an activist's involvement with their board (Figure 1). Even so, nearly two-thirds (63%) believe activism has not yet had an impact on their ability to attract quality members.

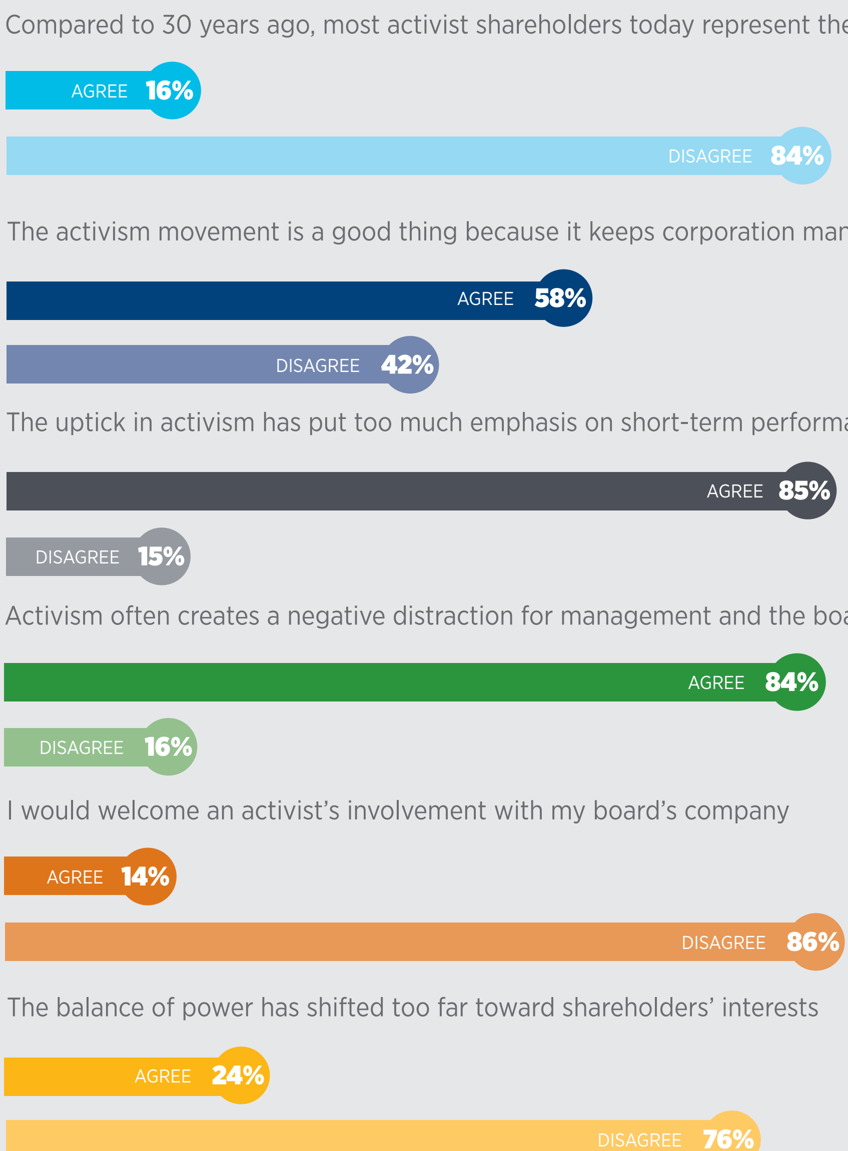
"Our conversations with board director candidates very much reflect the survey findings when it comes to the lack of impact activism has on recruitment," says Julie Daum, North American board practice leader, Spencer Stuart. "The majority of board candidates are more focused on finding an opportunity where they can make a meaningful impact than on the presence of an activist shareholder."

Activists, however, have board composition in their crosshairs. In case after case, activists are increasingly trying to gain board influence by nominating their own directors, a practice that has been bolstered legislatively by the passage of proxy access. When asked about the potential for conflict of interest with regard to an activists' slate, directors surveyed were more split: Nearly half (47%) say that directors who are nominated or placed on a board by an activist can remain independent, so long as they do not receive outside compensation from the activist.

HOW ACTIVISTS ARE ENGAGING AND INFLUENCING

Activism dominates corporate headlines and high-profile cases provide much fodder for boardroom concern, but for the vast majority of companies, according to the survey, it's been business as usual. Just 7% of companies surveyed said their company has postponed or abandoned an investment, capital project, or acquisition due to concerns about investment pressure.

FIGURE 1
DIRECTORS' PERCEPTION OF SHAREHOLDER ACTIVISM IN THE BOARDROOM



Perhaps driven in part by the pervasiveness of activism, however, companies are stepping up their practices and strategies related to engagement, especially on topics related to corporate governance, where 40% report having more interaction with investors, and company strategy, where 37% report an uptick in engagement.

Within companies that have been subject to an activist campaign/engagement within the past five years, the survey found that the four most common outcomes included the removal and replacement of directors (34%), a change in governance policies (33%), and a change in either capital allocation/management or in CEO/executive management (both 30%) (Figure 2). Only 6% responded there had either been no significant change in the boardroom or that the outcome had been positive, including the addition of directors with an increased focus on strategy and execution.

But ascertaining the impact of activism is more complicated, notes Bill Anderson, senior managing director and global head of the Strategic Shareholder Advisory Business at Evercore. Anderson points out that activist funds have registered subpar returns in the past few years, after a period of outperformance relative to other hedge funds.

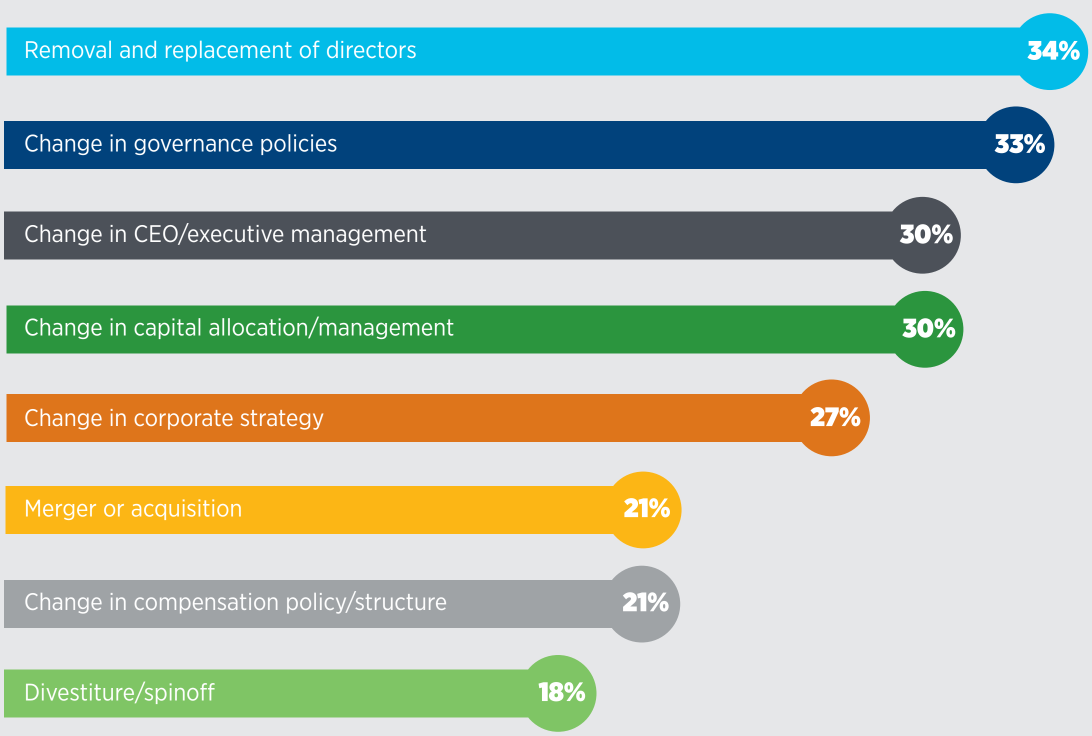
“For some companies, activists have been positive catalysts in creating shareholder value, while for others, they have had a mixed or negative influence,” says Anderson. More important, he notes, activism affects all companies even if they are not currently facing campaigns. “The topic dominates boardrooms in corporate America, and many point to activism as a driver of share repurchases.” According to Anderson, FactSet shows quarterly share buybacks are up 15.1% year-over-year in first quarter 2016, which marks a new post-recession high for quarterly buybacks in the S&P 500.

RULES OF CONDUCT

When it comes to rules surrounding investors’ ability to agitate for change, most (78%) directors believe activists should be required to hold company shares for one to three years. Almost 20% suggest this period should be increased to five years. (Figure 3).

FIGURE 2

OUTCOMES OF ACTIVIST CAMPAIGN/ENGAGEMENT WITHIN THE PAST FIVE YEARS



"Activist directors, once on the board, have the same stock holding and selling requirements as any other director," notes Anderson. "However, given that activist directors have a tendency to push for significant changes over a short period, there is a common view that those directors should be required to hold their shares for a specified time, regardless of whether they remain on the board, to ensure the activist funds 'feel' the longer-term economic impact of changes for which they've advocated. Clearly, the directors surveyed share this view, particularly given the notable situations where activists resigned from boards immediately after the change they advocated was implemented."

Most directors surveyed were in consensus regarding the rules and regulations that should apply to activists who serve or exercise their influence on boards. For instance, almost all the directors we surveyed (97%) agree that if an activist places a director on a board, that director should never be allowed to take confidential information back to the fund (Figure 4). A similar percentage of directors (95%) believe that the activist's fund should be subject to the same pledging and hedging restrictions that require companies to disclose whether they allow certain employees to hedge their stocks and options to determine alignment with shareholders' interests.

COMMUNICATIONS AND ENGAGEMENT

Two-thirds of the board members (63%) we surveyed in the fall of 2015 as part of our 2016 annual What Directors Think survey said they have a shareholder communications protocol in place and this more recent study shows that 63% continue to believe it's a good idea for the board to designate a committee or certain individuals to interact with large shareholders. At present, 86% say their shareholders primarily seek engagement with the CEO, followed by the IRO (36%), and then the board (30%) (Figure 5).

"There is no question investors are seeking greater access to and direct lines of communication with directors," agrees Daum of Spencer Stuart. "As a result, we are seeing more instances where boards are creating frameworks for investors to raise questions and engage in a thoughtful dialogue with the board. For some boards, an appropriate part of this framework includes a shareholder communications plan."

To minimize the threat of hostile activism campaigns and set the stage for more productive discussions, most governance advisers say boards should provide regular external communications that proactively address their strategy with shareholders, as well as listen and respond to outside concerns. In addition, taking a close look at governance policies is an advisable course of action, say legal and proxy advisers, a step many boards have undertaken, according to the study. Nearly three-fourths (71%) have initiated regular reviews of directors' skills to identify gaps; 56% have incorporated individual director assessments into their annual board evaluation; and 49% have established an investor communication framework.

FIGURE 3

HOW LONG SHOULD ACTIVISTS WHO PUSH FOR CHANGES IN STRATEGY BE REQUIRED TO HOLD THE SHARES SUBSEQUENT TO THE IMPLEMENTATION OF THAT STRATEGY?

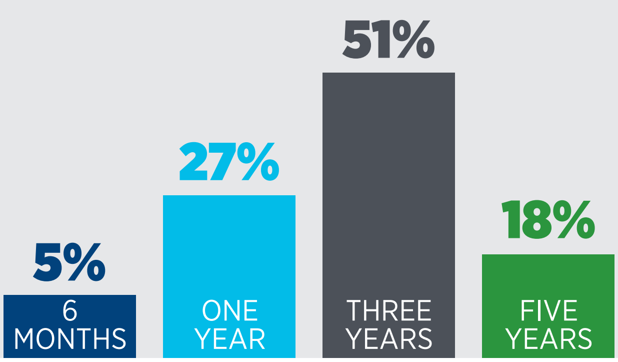


FIGURE 4

SHOULD ACTIVISTS WHO PLACE DIRECTORS ON BOARDS BE PERMITTED TO SHARE CONFIDENTIAL INFORMATION WITH OTHER MEMBERS OF THE FUND?

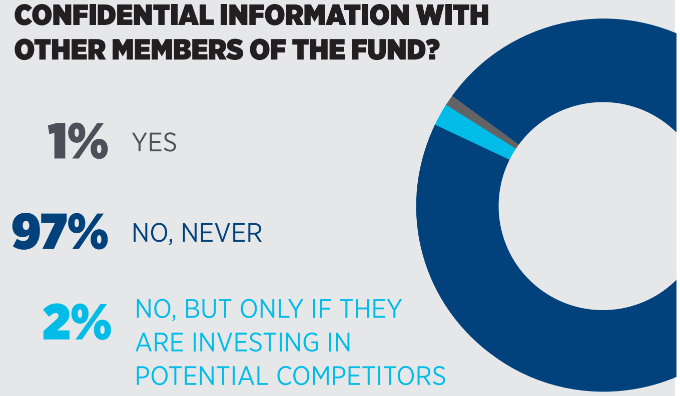
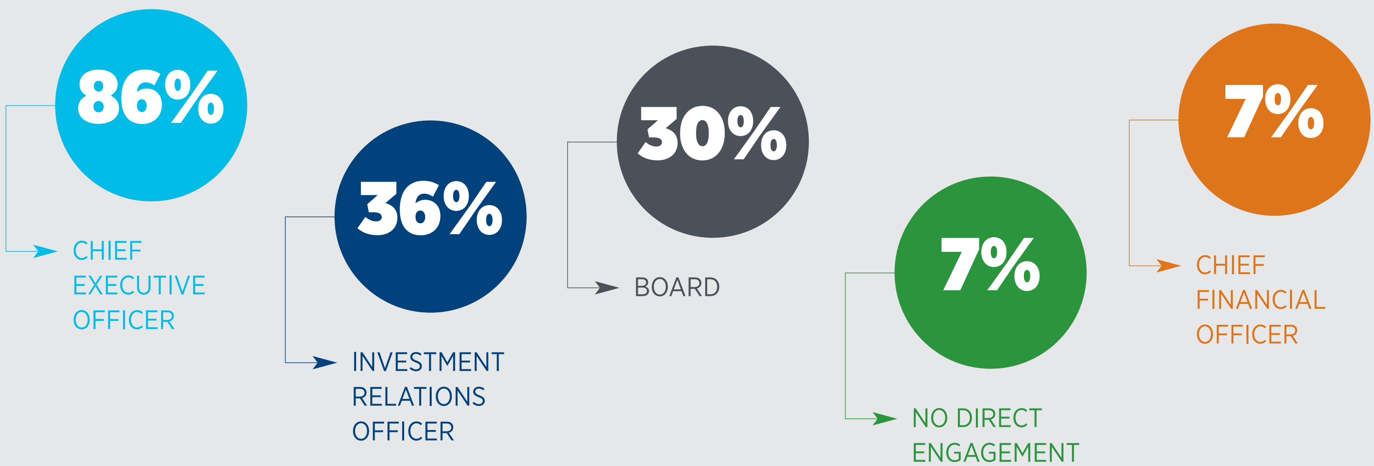


FIGURE 5
WITH WHOM HAVE INVESTORS SOUGHT ENGAGEMENT IN THE PAST YEAR?



"Expectations are growing that boards will provide greater transparency about the skills directors bring and why they possess the right expertise in light of the company's strategic direction," says Daum. Shareholders also want to know that boards are assessing their performance and holding directors to high standards. While boards are required to describe the skills and expertise each director brings, it's more common for boards to provide detailed skill matrices in their proxies. "Still," she continues, "a gap remains between what boards are communicating and what shareholders want to know."

ACTIVISM STRATEGIES AND DEFENSES

Activists often position their interest in a company as benefiting the wider base of shareholders, and today they are extremely skilled at using strategic communications and the media to manage and control their message. Most directors, however, are still skeptical of their benevolence—only 13% would welcome an activist's involvement and 84% believe it would create a negative distraction—yet 58% concede the movement is keeping boards and managements on their toes.

As with most issues, the analysis on whether shareholder activism is creating more valuable companies is not black and white, and there are myriad outcomes to support both premises. The message of many of our roundtable participants—activists, investors, CEOs, and directors who have been through activist campaigns—was for boards and management to initially keep an open mind to any proposals offered by activists and to engage in dialogue before shutting down. Balancing that, activists should likewise be encouraged to keep an open mind.

No matter what strategic options are on the table, boards have a fiduciary duty to remain independent, balanced, and objective with regard to what is best for their shareholder base. Activists' proposals that involve potential spinoffs, management transitions, share repurchases, and the like have both intended and unintended consequences, with high stakes for all corporate constituents. Therefore, it is vitally important for boards and managements to equally and thoroughly vet and understand their own strategy before either conceding to an activist or embarking on a costly, and potentially painful, proxy battle. In all cases, the best defense is having a strong, informed board that understands and supports its strategy for long-term growth and effectively communicates that plan to its shareholders.

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